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GLOBAL MARKET COMMENT: MSCI EAFE

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EAFE You Had Any Questions

MSCI is restructuring its global equity indexes to more accurately reflect trading opportunities in each market. These changes will improve the investability and liquidity of each index, as well as provide greater predictability and transparency to their methodology. However, with an estimated $2.3 trillion benchmarked against MSCI EAFE, the change will also increase turnover and transaction costs. Although the discussion below focuses on MSCI EAFE, over the next few weeks we will publish a more wide-ranging report about the changes to its other global indexes.

Transitioning to the New Index

On May 31, MSCI published a "new" Provisional EAFE Index, which is a parallel index to the "old" standard EAFE index. The transition to the Provisional Index will occur in two phases over the next year, allowing managers the flexibility to choose among staying with the "old" standard index for the time being, immediately adopting the new index, or gradually transitioning to the new index. As a result, the impact of this reconstitution is different from MSCI index changes in the past when the impact occurred on a single day. In the Provisional Index, 50% of the adjustment (but all of the deletions) will occur on November 30, 2001, while the remaining changes will take place on May 31, 2002. From that date, the Provisional Index will become the standard index. For example, MSCI added the Japanese company, NTT DoCoMo, to EAFE. The company's free-float factor is 35%, half of which (i.e., 17.5% of its total shares) will be included in November, while the full 35% will be included in May 2002.

MSCI has also expanded its index coverage to 85% of the available free float cap in a given market, which is up from 60% in the old standard index. Free float is the proportion of market capitalization that trades publicly and may differ from the total market capitalization because of partial government ownership, corporate crossholdings, controlling shareholder interests, limits on foreign ownership, and other restrictions.

Who Wins, Who Loses

The Provisional EAFE Index carries a market capitalization of $7.2 trillion, which is lower than the $8.2 trillion market cap of the standard index. MSCI added a net of 120 names to the new EAFE, bringing its total to 1,041 names (921 previously). This means that the average market cap for the reconstituted index is $6.9 billion, compared with $8.9 billion for the old standard index. The Provisional EAFE Index excludes many large and well-known stocks because MSCI may have achieved its 85% coverage target in a particular market without adding other large stocks. For example, large stocks that were omitted include Orange, Telefonica Moviles, BMW, and Japan Telecom. In addition, companies whose index weightings have been reduced as a result of the change to free-float weighting include NTT Corp., France Telecom, Toyota, and Deutsche Telecom. (However, because MSCI has not yet published an all-inclusive list of Provisional EAFE Index constituents—as it has with MSCI World and MSCI Emerging Markets Free—it is too early to conclude that the index's mid-cap component has increased.) Many analysts expect that the excluded stocks will undergo increased selling pressure in coming months as speculators unwind positions that they may have put on in anticipation of their inclusion.

Among countries, the U.K. weighting increased the most (five percentage points) in the Provisional EAFE Index, and it now accounts for 26.6% of the index's market cap (see Table A). The United Kingdom's gain means that other countries have lost weight. For example, the capitalization of France fell 1.7 percentage points to 9.3%, Germany, 1.3 points to 7.1%, and Italy 0.9 points to 3.6%. As a result, the weight of Europe ex U.K. fell 3.7 percentage points to 43.9%. Analysts had expected Japan's market cap to decline significantly due to its large number of crossholdings, but because MSCI has expanded its coverage of the market, its capitalization fell only one percentage point to 23.7%.

The reconstitution has also resulted in significant changes to industry and sector weightings (see Table B). Among industry groups, energy enjoyed the largest increase in market cap, up 1.5 percentage points to 8.4% (primarily due to the inclusion of Shell Transport, 4.6%), while the technology hardware sector rose 0.7 points to 8.1%. The telecom services sector suffered the largest decline, 0.9 points to 8.4%, due to the low free float of national telecom companies.

The Costs of Changing

Passive managers have reacted proactively to the restructuring by switching immediately to the Provisional Index or announcing plans to transition over the year. Active managers, however, thus far appear to be content to wait until Phase 2 of the rebalancing in May 2002, though some may change earlier, hoping to outperform the benchmark.

Although the restructuring will more accurately reflect trading opportunities in each market, it will also entail higher costs in terms of turnover, relative performance, and higher volatility. With an estimated $2.3 trillion in passive and active money benchmarked against EAFE, turnover (roundtrip) will increase about 30% over the next year. In addition, over the next 12 months stocks that were added to the index and those whose weight in the index has increased will probably outperform those whose weight has decreased. Goldman Sachs suggests that this will probably cause the new EAFE to outperform the old EAFE by one to two percentage points. Goldman Sachs also expects tracking error to increase by about a percentage point. Managers who avoid the windows around the fixed transition dates in November 2001 and May 2002 may experience increased tracking error, but the transition should be relatively less expensive.

Salomon Smith Barney is taking advantage of these increased costs to push its own free-float adjusted index. It argues that its index is a purer form of free float, and warns investors about benchmark risk associated with changing to the Provisional EAFE Index, as well as the risk that the added constituents will significantly outperform those remaining or deleted. Not surprisingly, it contends that converting to the Salomon Smith Barney Primary Market Index EPAC portfolio will be less expensive than switching to the new EAFE index or to the float-adjusted FTSE World ex U.S. Index (15 bps, compared to 29 and 35 bps, respectively). However, a State Street Bank study argues that, after MSCI's restructuring, the methodological differences among the indexes do not appear to be very significant and that MSCI indexes should enjoy a much higher degree of liquidity. State Street contends that switching to another index will probably cost more than staying with MSCI.

The free-float adjustment to MSCI's global indexes are a welcome event, if overdue. Investors who benchmark against the EAFE index should expect slightly higher turnover and tracking error over the next year, but over the longer term a free-float adjusted index is a much more accurate reflection of trading realities.

Table A

MSCI EAFE AND MSCI PROVISIONAL EAFE COUNTRY COMPARISON

June 1, 2001

	MSCI Provisional Index	MSCI Standard Index
MSCI Austria	0.1	0.2
MSCI Belgium	0.7	0.9
MSCI Denmark	0.7	0.9
MSCI Finland	2.4	2.1
MSCI France	9.3	11.0
MSCI Germany	7.1	8.4
MSCI Greece	0.4	0.4
MSCI Ireland	0.9	0.7
MSCI Italy	3.6	4.5
MSCI Netherlands	5.7	5.5
MSCI Norway	0.4	0.5
MSCI Portugal	0.3	0.5
MSCI Spain	3.0	3.1
MSCI Sweden	2.1	2.2
MSCI Switzerland	7.3	6.7
MSCI United Kingdom	26.6	21.6
MSCI Europe	70.5	69.2
MSCI Australia	3.4	3.0
MSCI Hong Kong	1.6	2.1
MSCI Japan	23.7	24.7
MSCI New Zealand	0.1	0.1
MSCI Singapore	0.7	0.9
MSCI Pacific	29.5	30.8
MSCI EAFE	100.0	100.0

Source: Datastream International. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Figures may not total due to rounding.

Table B

MSCI EAFE AND MSCI PROVISIONAL EAFE INDUSTRY GROUP COMPARISON

May 18, 2001

	MSCI Provisional Index	MSCI Standard Index
Automobiles & Components	3.4	4.1
Banks	14.6	15.0
Capital Goods	5.9	6.7
Commercial Services & Supplies	1.2	1.2
Consumer Durables & Apparel	4.0	4.2
Diversified Financials	3.4	3.2
Energy	8.4	6.9
Food & Drug Retailing	1.8	1.7
Food Beverage & Tobacco	4.3	4.2
Health Care Equipment & Services	0.6	0.5
Hotels Restaurants & Leisure	1.0	1.1
Household & Personal Products	0.8	0.9
Insurance	4.9	5.4
Materials	5.5	5.1
Media	3.6	3.5
Pharmaceuticals & Biotechnology	9.1	8.8
Real Estate	1.4	1.3
Retailing	1.9	2.0
Software & Services	1.8	1.5
Technology Hardware & Equipment	8.1	7.4
Telecommunication Services	8.4	9.3
Transportation	2.0	2.3
Utilities	4.1	4.0
Total	100.0	100.0

Source: Morgan Stanley Quantitative Strategies. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Figures may not total due to rounding.